CalPERS

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AGENDA ITEM 3b

TO: MEMBERS OF THE INVESTMENT POLICY SUBCOMMITTEE

I. SUBJECT: Adoption of Policy on Supplemental Income Plans CalPERS Risk-Based and Target Retirement Date Funds Policy

II. PROGRAM: Supplemental Income Plans

III. RECOMMENDATION: Recommend to the Investment Committee adoption of the Statement of Investment Policy for Supplemental Income Plans CalPERS Risk-Based and Target Retirement Date Funds

IV. ANALYSIS:

On February 19, 2008, the Investment Committee approved the creation of the custom CalPERS Asset Allocation Funds for the Supplemental Income Plans (SIP) with the use of a consultant from the General Pension Consultant Spring-fed Pool to advise on their development. Callan Associates was selected for this assignment. This Policy (Attachment 1) is the culmination of this work. Wilshire Associates has provided an opinion letter (Attachment 2) supportive of the policy provisions.

BACKGROUND

The SIP offer three supplemental retirement income plans as complements to the CalPERS pension plan.

The CalPERS 457 Plan is an employer sponsored, deferred compensation plan offered to local public agencies and school districts. This plan accepts employer and employee tax-deferred contributions.

The CalPERS Supplemental Contributions Plan (SCP) is an after-tax contributions plan where earnings accrue tax-deferred. To date, this Plan is offered only to CalPERS members who are State employees and accepts employee contributions only.

The CalPERS Peace Officers and Fire Fighters Plan (POFF) is offered to State Department of Corrections employees. This plan accepts only employer contributions at a rate of 2% of employees' salary.

Enhanced Investment Funds

Participants in the 457 Plan and the SCP can choose from a series of high quality funds consisting of Core Funds, Risk-Based Funds and Target Retirement Date Funds. Currently the Asset Allocation Funds are managed by State Street Global Advisors. The proposed policy identifies custom CalPERS funds developed by the Investment Office staff along with Callan Associates. In addition, the Actuarial Office has contributed staff and expertise on CalPERS member demographic data to make the Target Retirement Date Funds most relevant to SIP participants.

- The Risk-Based Funds offer varying asset allocations designed to suit varying participant risk profiles. Three Risk-Based Funds will be offered: Conservative, Moderate and Aggressive. The Moderate Risk-Based Fund will replace both the existing SCP internally managed fund and the externally managed POFF fund.

- The Target Retirement Date Funds offer an automatically adjusting mix of investments designed to become increasingly conservative as the participant nears and then enters retirement. The funds will be offered in five year increments, beginning with the 2050 Fund and ending with the Income Fund.

All of these funds are asset allocation funds. They are constructed using a building block approach by first determining the desired asset classes and then selecting a specific fund to represent each asset class. These asset allocation funds include separate strategic allocation to investments such as commodities and emerging markets. Staff has selected specific funds to include both internally and externally managed funds. Fund selection focused on optimizing in-house talent and risk adjusted returns while keeping fees low. The externally managed funds were selected from firms already managing assets for CalPERS.

DESCRIPTION AND RATIONALE OF PROPOSED FUNDS

Risk-Based Funds

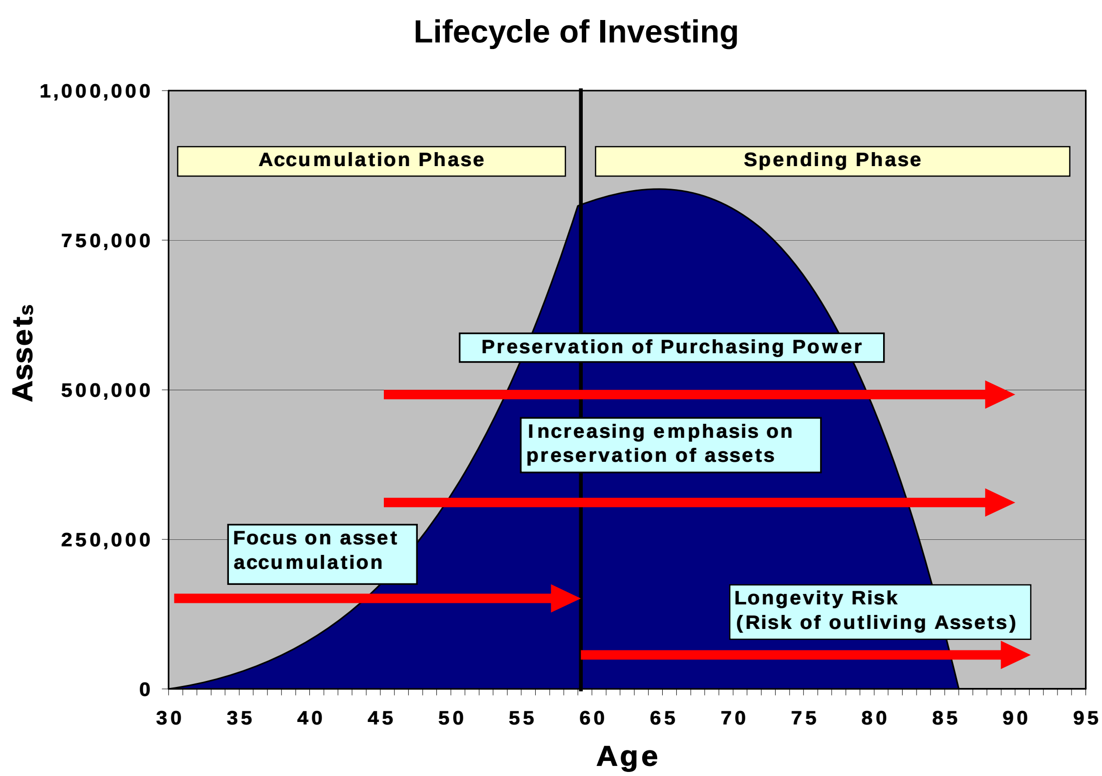
These funds have asset allocation strategies which remain constant within allowed ranges. Each fund is designed to conform to a certain risk tolerance, described as conservative, moderate, or aggressive. The proposed Policy identifies the target, permissible range, and benchmark of each asset class. With this information included in Policy, any change in these key Program measures must be updated in Policy and approved by the Committee. The proposed inclusion of asset class targets and ranges in Policy results in greater clarity and transparency.

Target Retirement Date Funds

These funds have asset allocation strategies that are designed to change over time. This dynamic asset allocation strategy is called a glidepath. Glidepaths are designed to gradually reduce the level of risk until and often into retirement. The "target date" typically refers to the date the individual retires. The proposed Policy identifies the target asset allocation, permissible range, and benchmark of each asset class.

Target Retirement Date Funds simplify the investment process by recognizing that participant risk tolerances change over time. On the contrary, Risk-Based Funds have static asset allocations and participants must proactively switch funds as their risk tolerance changes.

Participants benefit from favoring higher returning assets in their earlier years (Accumulation Phase) and favoring capital preserving assets in their later years (Spending Phase). This concept is illustrated in the graph below.



Participants can choose from two basic approaches in saving for retirement with their self directed assets. They can invest in Risk-Based Funds and individual core funds (i.e., S&P 500 fund, the Fixed Income Fund) or both, and alter their allocations over time per their own Lifecycle of Investing. Or they can invest in the Target Retirement Date Funds and delegate the asset allocation process to professional managers. Target Retirement Date Funds have become popular because they greatly simplify the asset allocation and fund selection effort for participants who often lack the time, knowledge and inclination to make these decisions themselves. Research supports the conclusion that professionally designed and managed asset allocation funds are likely to be superior to the allocations developed by individual participants. The success of Target Retirement Date Funds is demonstrated by the growth of the number of available target date mutual funds from zero in 1994 to approximately thirty in 2007 (source: Morningstar).

CONSTRUCTING CALPERS TARGET RETIREMENT DATE FUNDS

The task of designing Target Retirement Date Funds is unique in the importance of the time dimension. The Lifecycle of Investing graph separates the process into two distinct phases: the accumulation phase and the spending phase.

The accumulation phase can be described in terms of two general categories of savers. Young savers (age 25-40) have relatively small savings but a large future expected earnings stream. These participants need to invest aggressively to seek higher returns, emphasizing equities and minimizing fixed income. Midlife savers (age 40-55) have accumulated significant savings and still have very long investment horizons. These savers still need to seek high returns but gradually reduce risk as retirement approaches. They will benefit from increased exposure to core fixed income and the introduction of stable value and treasury inflation protected securities (TIPS).

The spending phase begins with new retirees (age 50-70). New retirees have depleted their earnings stream and must rely on their savings to fund their spending needs. New retirees face three risks – inflation risk, longevity risk and market risk. A high inflationary environment can erode the purchasing power of a participant's accumulated assets, thus, inflation hedging assets such as TIPs and commodities play an important role in the glidepath for participants age 50 and older. Although the ability for a new retiree to assume risk is constrained, the glidepath recommends an appropriate amount of exposure to return-generating asset classes. Equities best fit this role by generating attractive long term returns to help minimize the probability of outliving assets (longevity risk). Senior retirees (age 75+) are beginning to deplete their savings and must limit capital losses while placing greater emphasis on principle preservation. Older retirees benefit from increasing exposures to core fixed income, stable value and TIPS, and decreasing exposures to equities.

Risk Considerations

Target Retirement Date Funds feature unique risk considerations different from the CalPERS defined benefit retirement fund (PERF). The PERF is a commingled group of assets with no termination date. The risk of the PERF can largely be evaluated in terms of assumptions for expected return and standard deviation, and these assumptions are extended into the future.

Target Retirement Date Funds also use expected return and standard deviation as key assumptions for each asset class. These funds, however, are more complicated in the sense that they are tailored according to the characteristics of their participants. The following key factors were considered based on participant data:

- Retirement Objective
    - Projected income replacement ratio
- Demographics
    - Expected retirement age and remaining years of work
    - Savings level and pattern
    - Average salary and growth rate
- Other Sources of Retirement Income
    - Defined Benefit Pension Plan
    - Social Security benefits
- Risk Tolerance
    - High risk/return or low risk/return path?

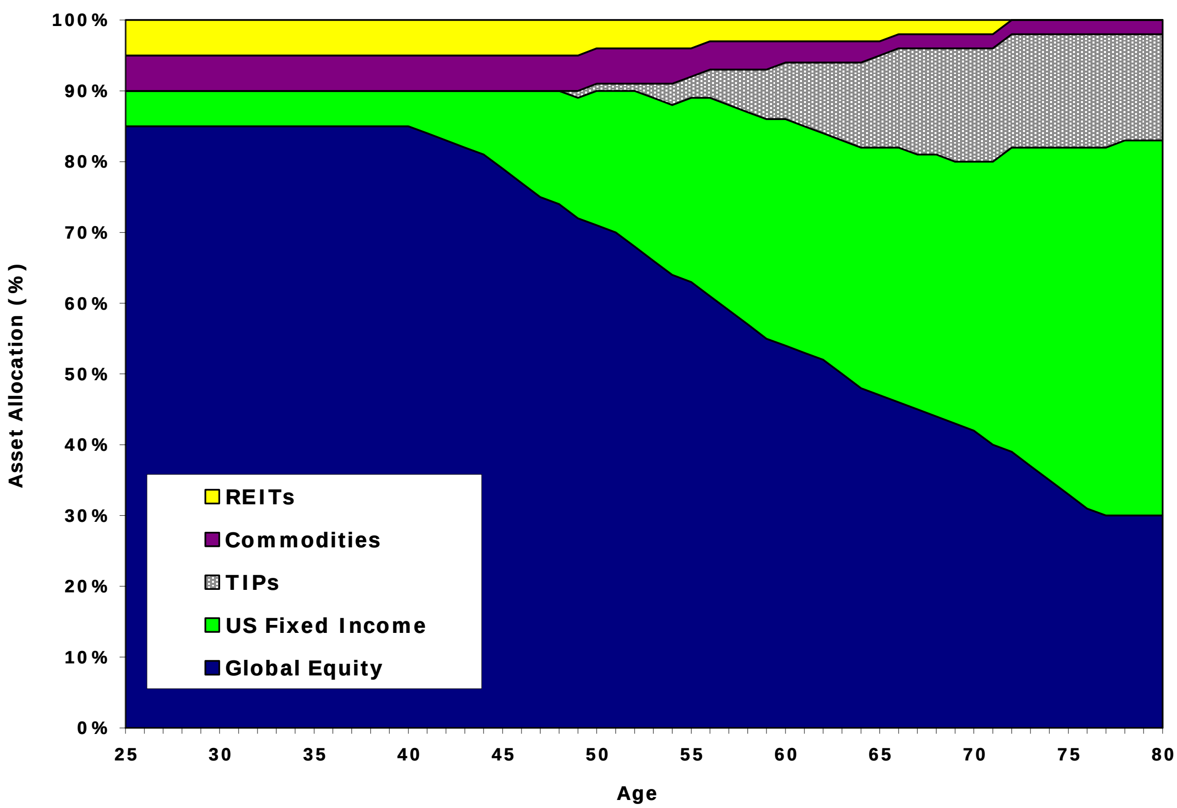
Among other criteria, the Target Date Retirement Funds were constructed with the goal of maximizing the probability of the projected income replacement ratio exceeding 24%, on average. The target replacement ratio was arrived at based on detailed analysis of demographic data, other sources of wealth and risk tolerance. Two related key factors in this analysis are 1) the fact that the vast majority of participants are covered under a CalPERS defined benefit plan, which provides a large replacement ratio for career service workers and 2) the savings level of most participants is 2-8% (a higher savings level will lead to much higher projected replacement ratios). Participants are expected to achieve retirement adequacy from three sources of retirement income: CalPERS defined benefit pension income, the Target Date Retirement Funds and possibly social security.

The incidence of retirements was carefully analyzed when constructing the glidepath. Currently, the average expected retirement age for all participants is 59 years old. Sensitivity analysis was performed to test retirement at various ages since age 59 only represents the median of the retirement incidence distribution. Additional factors considered were a general trend towards longer life expectancy and potential increases in the social security normal retirement age. As a result of this analysis, an anticipated retirement age of 62 influenced the construction of the Target Date Retirement Funds.

The following risks were considered in constructing the funds:

- Shortfall Risk
    - Having insufficient funds at retirement.
- Market Risk
    - The proportion of lower risk assets is increased to protect against capital losses.
- Inflation Risk
    - Inflation hedging assets (TIPS and commodities) are introduced for midlife savers.
- Longevity Risk
    - The risk that the retiree outlives their assets. It is important to hold some growth assets, especially for a new retiree.

The glidepath for the CalPERS Target Retirement Date Funds is shown below. High allocations to equity securities in the early years are replaced with allocations to fixed income securities in the later years.



CONSTRUCTING CALPERS RISK-BASED FUNDS

The three Risk-Based Funds are derived from the Target Retirement Date Funds glidepath, recognizing that the 2050 Fund is the most aggressive and the Income Fund is the most conservative of the funds (see glidepath in the Policy

Attachment A). The Aggressive Risk-Based Fund is constructed to match ages 40 and under, the Moderate Risk-Based Fund is constructed to match approximately age 55, and the Conservative Risk-Based Fund is constructed to match ages 75+ (the Income Fund).

V. STRATEGIC PLAN:

This agenda item addresses multiple CalPERS Strategic Plan Goals including:

- Goal (VI) to Administer pension benefit services in a customer-oriented and cost effective manner;
- Goal (VII) to Enable and educate members and employers to make informed decisions leading to a predictable and secure retirement future; and
- Goal (IX) to Achieve long-term, sustainable, risk-adjusted returns.

VI. RESULTS/COSTS:

The customized asset allocation funds offer enhanced funds for the participants. There are no additional costs associated with this agenda.

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